

Financial Accounting Series

FASB Interpretation No. 46

Consolidation of Variable Interest Entities

an interpretation of ARB No. 51



Financial Accounting Standards Board

of the Financial Accounting Foundation

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Summary

This Interpretation of Accounting Research Bulletin No. 51, *Consolidated Financial Statements*, addresses consolidation by business enterprises of variable interest entities,* which have one or both of the following characteristics:

1. The equity investment at risk is not sufficient to permit the entity to finance its activities without additional subordinated financial support from other parties, which is provided through other interests that will absorb some or all of the expected losses of the entity.
2. The equity investors lack one or more of the following essential characteristics of a controlling financial interest:
 - a. The direct or indirect ability to make decisions about the entity's activities through voting rights or similar rights
 - b. The obligation to absorb the expected losses of the entity if they occur, which makes it possible for the entity to finance its activities
 - c. The right to receive the expected residual returns of the entity if they occur, which is the compensation for the risk of absorbing the expected losses.

The following are exceptions to the scope of this Interpretation:

1. Not-for-profit organizations are not subject to this Interpretation unless they are used by business enterprises in an attempt to circumvent the provisions of this Interpretation.
2. Employee benefit plans subject to specific accounting requirements in existing FASB Statements are not subject to this Interpretation.
3. Registered investment companies are not required to consolidate a variable interest entity unless the variable interest entity is a registered investment company.
4. Transferors to qualifying special-purpose entities and "grandfathered" qualifying special-purpose entities subject to the reporting requirements of FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, do not consolidate those entities.

*The Exposure Draft that preceded this Interpretation referred to the entities subject to its requirements as special-purpose entities (SPEs). Because some entities that have been commonly referred to as SPEs may not be subject to this Interpretation and other entities that have not commonly been referred to as SPEs may be subject to this Interpretation, the Board decided to use the term *variable interest entity*.

5. No other enterprise consolidates a qualifying special-purpose entity or a “grandfathered” qualifying special-purpose entity unless the enterprise has the unilateral ability to cause the entity to liquidate or to change the entity in such a way that it no longer meets the requirements to be a qualifying special-purpose entity or “grandfathered” qualifying special-purpose entity.
6. Separate accounts of life insurance enterprises as described in AICPA Auditing and Accounting Guide, *Life and Health Insurance Entities*, are not subject to this Interpretation.

Reason for Issuing This Interpretation

Transactions involving variable interest entities have become increasingly common, and the relevant accounting literature is fragmented and incomplete. ARB 51 requires that an enterprise’s consolidated financial statements include subsidiaries in which the enterprise has a controlling financial interest. That requirement usually has been applied to subsidiaries in which an enterprise has a majority voting interest, but in many circumstances the enterprise’s consolidated financial statements do not include variable interest entities with which it has similar relationships. The voting interest approach is not effective in identifying controlling financial interests in entities that are not controllable through voting interests or in which the equity investors do not bear the residual economic risks.

The objective of this Interpretation is not to restrict the use of variable interest entities but to improve financial reporting by enterprises involved with variable interest entities. The Board believes that if a business enterprise has a controlling financial interest in a variable interest entity, the assets, liabilities, and results of the activities of the variable interest entity should be included in consolidated financial statements with those of the business enterprise.

Differences between This Interpretation and Current Practice

Under current practice, two enterprises generally have been included in consolidated financial statements because one enterprise controls the other through voting interests. This Interpretation explains how to identify variable interest entities and how an enterprise assesses its interests in a variable interest entity to decide whether to consolidate that entity. This Interpretation requires existing unconsolidated variable interest entities to be consolidated by their primary beneficiaries if the entities do not effectively disperse risks among parties involved. Variable interest entities that effectively disperse risks will not be consolidated unless a single party holds an interest or combination of interests that effectively recombines risks that were previously dispersed.

An enterprise that consolidates a variable interest entity is the primary beneficiary of the variable interest entity. The primary beneficiary of a variable interest entity is the party that absorbs a majority of the entity's expected losses, receives a majority of its expected residual returns, or both, as a result of holding variable interests, which are the ownership, contractual, or other pecuniary interests in an entity. The ability to make decisions is not a variable interest, but it is an indication that the decision maker should carefully consider whether it holds sufficient variable interests to be the primary beneficiary. An enterprise with a variable interest in a variable interest entity must consider variable interests of related parties and de facto agents as its own in determining whether it is the primary beneficiary of the entity.

Assets, liabilities, and noncontrolling interests of newly consolidated variable interest entities generally will be initially measured at their fair values except for assets and liabilities transferred to a variable interest entity by its primary beneficiary, which will continue to be measured as if they had not been transferred. If recognizing those assets, liabilities, and noncontrolling interests at their fair values results in a loss to the consolidated enterprise, that loss will be reported immediately as an extraordinary item. If recognizing those assets, liabilities, and noncontrolling interests at their fair values would result in a gain to the consolidated enterprise, that amount will be allocated to reduce the amounts assigned to assets in the same manner as if consolidation resulted from a business combination. However, assets, liabilities, and noncontrolling interests of newly consolidated variable interest entities that are under common control with the primary beneficiary are measured at the amounts at which they are carried in the consolidated financial statements of the enterprise that controls them (or would be carried if the controlling entity prepared financial statements) at the date the enterprise becomes the primary beneficiary. After initial measurement, the assets, liabilities, and noncontrolling interests of a consolidated variable interest entity will be accounted for as if the entity were consolidated based on voting interests. In some circumstances, earnings of the variable interest entity attributed to the primary beneficiary arise from sources other than investments in equity of the entity.

An enterprise that holds significant variable interests in a variable interest entity but is not the primary beneficiary is required to disclose (1) the nature, purpose, size, and activities of the variable interest entity, (2) its exposure to loss as a result of the variable interest holder's involvement with the entity, and (3) the nature of its involvement with the entity and date when the involvement began. The primary beneficiary of a variable interest entity is required to disclose (a) the nature, purpose, size, and activities of the variable interest entity, (b) the carrying amount and classification of consolidated assets that are collateral for the variable interest entity's obligations, and (c) any lack of recourse by creditors (or beneficial interest holders) of a consolidated variable interest entity to the general credit of the primary beneficiary.

How This Interpretation Will Improve Financial Reporting

This Interpretation is intended to achieve more consistent application of consolidation policies to variable interest entities and, thus, to improve comparability between enterprises engaged in similar activities even if some of those activities are conducted through variable interest entities. Including the assets, liabilities, and results of activities of variable interest entities in the consolidated financial statements of their primary beneficiaries will provide more complete information about the resources, obligations, risks, and opportunities of the consolidated enterprise. Disclosures about variable interest entities in which an enterprise has a significant variable interest but does not consolidate will help financial statement users assess the enterprise's risks.

How the Conclusions in This Interpretation Relate to the Conceptual Framework

FASB Concepts Statement No. 1, *Objectives of Financial Reporting by Business Enterprises*, states that financial reporting should provide information that is useful in making business and economic decisions. Including variable interest entities in consolidated financial statements with the primary beneficiary will help achieve that objective by providing information that helps in assessing the amounts, timing, and uncertainty of prospective net cash flows of the consolidated entity.

Completeness is identified in FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information*, as an essential element of representational faithfulness and relevance. Thus, to faithfully represent the total assets that an enterprise controls and liabilities for which an enterprise is responsible, assets and liabilities of variable interest entities for which the enterprise is the primary beneficiary must be included in the enterprise's consolidated financial statements.

FASB Concepts Statement No. 6, *Elements of Financial Statements*, defines *assets*, in part, as probable future economic benefits obtained or controlled by a particular entity and defines *liabilities*, in part, as obligations of a particular entity to make probable future sacrifices of economic benefits. The relationship between a variable interest entity and its primary beneficiary results in control by the primary beneficiary of future benefits from the assets of the variable interest entity even though the primary beneficiary may not have the direct ability to make decisions about the uses of the assets. Because the liabilities of the variable interest entity will require sacrificing consolidated assets, those liabilities are obligations of the primary beneficiary even though the creditors of the variable interest entity may have no recourse to the general credit of the primary beneficiary.

The Effective Date of This Interpretation

This Interpretation applies immediately to variable interest entities created after January 31, 2003, and to variable interest entities in which an enterprise obtains an interest after that date. It applies in the first fiscal year or interim period beginning after June 15, 2003, to variable interest entities in which an enterprise holds a variable interest that it acquired before February 1, 2003. The Interpretation applies to public enterprises as of the beginning of the applicable interim or annual period, and it applies to nonpublic enterprises as of the end of the applicable annual period.

This Interpretation may be applied prospectively with a cumulative-effect adjustment as of the date on which it is first applied or by restating previously issued financial statements for one or more years with a cumulative-effect adjustment as of the beginning of the first year restated.

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Consolidation of Variable Interest Entities

an interpretation of ARB No. 51

January 2003



Financial Accounting Standards Board
of the Financial Accounting Foundation

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CONTENTS

	Paragraph Numbers
Introduction	1
Interpretation.....	2–22
Definition of Terms	2– 3
Use of the Term <i>Entity</i>	3
Scope.....	4
Variable Interest Entities	5–11
Expected Losses and Expected Residual Returns	8–10
Development Stage Enterprises	11
Variable Interests and Interests in Specified Assets of a Variable Interest Entity.....	12–13
Consolidation Based on Variable Interests.....	14–17
Related Parties	16–17
Initial Measurement	18–21
Accounting after Initial Measurement.....	22
Disclosure	23–25
Effective Date and Transition.....	26–29
Appendix A: Expected Losses, Expected Residual Returns, and Expected Variability	A1–A5
Appendix B: Variable Interests.....	B1–B12
Appendix C: Background Information and Basis for Conclusions	C1–C50
Appendix D: Effect of This Interpretation on EITF Issues.....	D1–D4

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INTRODUCTION

1. This Interpretation clarifies the application of Accounting Research Bulletin No. 51, *Consolidated Financial Statements*, to certain entities in which equity investors do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties. Paragraph 1 of ARB 51 states that consolidated financial statements are “usually necessary for a fair presentation when one of the companies in the group directly or indirectly has a controlling financial interest in the other companies.” Paragraph 2 states that “the usual condition for a controlling financial interest is ownership of a majority voting interest. . . .” However, application of the majority voting interest requirement in ARB 51 to certain types of entities may not identify the party with a controlling financial interest because the controlling financial interest may be achieved through arrangements that do not involve voting interests.

INTERPRETATION

Definition of Terms

2. Certain terms are defined for use in this Interpretation as follows:
 - a. *Variable interest entity* refers to an entity subject to consolidation according to the provisions of this Interpretation.
 - b. *Expected losses* and *expected residual returns* refer to amounts derived from expected cash flows as described in FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*. However, expected losses and expected residual returns refer to amounts discounted and otherwise adjusted for market factors and assumptions rather than to undiscounted cash flow estimates. Paragraph 8 specifies which amounts are to be considered in determining

expected losses and expected residual returns of a variable interest entity. *Expected variability* is the sum of the absolute values of the expected residual return and the expected loss. All three concepts are illustrated in Appendix A.

- c. *Variable interests* in a variable interest entity are contractual, ownership, or other pecuniary interests in an entity that change with changes in the entity's net asset value. Equity interests with or without voting rights are considered variable interests if the entity is a variable interest entity. Paragraph 12 explains how to determine whether a variable interest in specified assets of an entity is a variable interest in the entity. Appendix B describes various types of variable interests and explains in general how they affect the determination of the primary beneficiary of a variable interest entity.
- d. *Primary beneficiary* refers to an enterprise that consolidates a variable interest entity under the provisions of this Interpretation.
- e. *Subordinated financial support* refers to variable interests that will absorb some or all of an entity's expected losses if they occur.

Use of the Term *Entity*

3. For convenience, this Interpretation uses the term *entity* to refer to any legal structure used to conduct activities or to hold assets. Some examples of such structures are corporations, partnerships, limited liability companies, grantor trusts, and other trusts. Portions of entities or aggregations of assets within an entity shall not be treated as separate entities for purposes of applying this Interpretation unless the entire entity is a variable interest entity. Some examples are divisions, departments, branches, and pools of assets subject to liabilities that give the creditor no recourse to other assets of the entity. Majority-owned subsidiaries are entities separate from their parents that are subject to this Interpretation and may be variable interest entities.

Scope

- 4. With the following exceptions, this Interpretation applies to all entities:
 - a. Not-for-profit organizations subject to the consolidation requirements of AICPA Statement of Position 94-3, *Reporting of Related Entities by Not-for-Profit Organizations*, are not subject to this Interpretation, except that they may be related parties for purposes of applying paragraphs 16 and 17 of this Interpretation. In addition, if a not-for-profit entity is used by business enterprises in a manner similar to a variable interest entity in an effort to circumvent the provisions of this Interpretation, that not-for-profit entity shall be subject to this Interpretation.

- b. An employer shall not consolidate an employee benefit plan subject to the provisions of FASB Statements No. 87, *Employers' Accounting for Pensions*, No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*, and No. 112, *Employers' Accounting for Postemployment Benefits*.
- c. Neither a transferor of financial assets nor its affiliates shall consolidate a qualifying special-purpose entity as described in paragraph 35 of FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, or a "formerly qualifying SPE" as described in paragraph 25 of Statement 140. A transferor reports its rights and obligations related to the qualifying special-purpose entity according to the requirements of Statement 140.
- d. An enterprise that holds variable interests in a qualifying special-purpose entity or a "formerly qualifying SPE," as described in paragraph 25 of Statement 140, shall not consolidate that entity unless that enterprise has the unilateral ability to cause the entity to liquidate or to change the entity so that it no longer meets the conditions in paragraph 25 or 35 of Statement 140. If the entity is not consolidated, the enterprise reports its rights and obligations related to the entity.
- e. An enterprise subject to SEC Regulation S-X Rule 6-03(c)(1) shall not consolidate any entity that is not also subject to that same rule.
- f. Separate accounts of life insurance entities as described in the AICPA Audit and Accounting Guide, *Life and Health Insurance Entities*, are not subject to consolidation according to the requirements of this Interpretation.

Variable Interest Entities

5. An entity shall be subject to consolidation according to the provisions of this Interpretation if, by design,¹ either of the following conditions exists:
- a. The total equity investment² at risk is not sufficient to permit the entity to finance its activities without additional subordinated financial support from other parties. That is, the equity investment at risk is not greater than the expected losses of the entity. (Refer to Appendix A for discussion of expected losses.) For this purpose, the total equity investment at risk:
 - (1) Includes only equity investments in the entity that participate significantly in profits and losses even if those investments do not carry voting rights

¹The phrase *by design* refers to entities that meet the conditions in this paragraph because of the way they are structured. For example, an enterprise under the control of its equity investors that originally was not a variable interest entity does not become one because of operating losses.

²Equity investments in an entity are interests that are required to be reported as equity in that entity's financial statements.

- (2) Does not include equity interests that the entity issued in exchange for subordinated interests in other variable interest entities
- (3) Does not include amounts provided to the equity investor directly or indirectly by the entity or by other parties involved with the entity (for example, by fees, charitable contributions, or other payments), unless the provider is a parent, subsidiary, or affiliate of the investor that is required to be included in the same set of consolidated financial statements as the investor
- (4) Does not include amounts financed for the equity investor (for example, by loans or guarantees of loans) directly by the entity or by other parties involved with the entity, unless that party is a parent, subsidiary, or affiliate of the investor that is required to be included in the same set of consolidated financial statements as the investor.

Paragraphs 8–10 discuss the amount of the total equity investment at risk that is necessary to permit an entity to finance its activities.

- b. As a group the holders of the equity investment at risk lack any one of the following three characteristics of a controlling financial interest:
 - (1) The direct or indirect ability to make decisions about an entity’s activities through voting rights or similar rights. The investors do not have that ability through voting rights or similar rights if no owners hold voting rights or similar rights (such as those of a common shareholder in a corporation or a general partner in a partnership).³
 - (2) The obligation to absorb the expected losses of the entity if they occur.⁴ The investor or investors do not have that obligation if they are directly or indirectly protected from the expected losses or are guaranteed a return by the entity itself or by other parties involved with the entity.

³Enterprises that are not controlled by the holder of a majority voting interest because of minority veto rights as discussed in EITF Issue No. 96-16, “Investor’s Accounting for an Investee When the Investor Has a Majority of the Voting Interest but the Minority Shareholder or Shareholders Have Certain Approval or Veto Rights,” are not variable interest entities if the shareholders as a group have the power to control the enterprise and the equity investment meets the other requirements of this Interpretation.

⁴The phrase *if they occur* is used because no interest absorbs expected losses or receives expected residual returns unless they occur. It is not intended to imply that no determination need be made until expected losses or expected residual returns occur.

- (3) The right to receive the expected residual returns of the entity if they occur. The investors do not have that right if their return is capped by the entity's governing documents or arrangements with other variable interest holders or with the entity.⁵

The equity investors as a group also are considered to lack characteristic (b)(1) if (i) the voting rights of some investors are not proportional to their obligations to absorb the expected losses of the entity, to receive the expected residual returns of the entity, or both and (ii) substantially all of the entity's activities (for example, providing financing or buying assets) either involve or are conducted on behalf of an investor⁶ that has disproportionately few voting rights.⁷

6. An entity subject to this Interpretation is called a variable interest entity. The investments or other interests that will absorb portions of a variable interest entity's expected losses if they occur or receive portions of the entity's expected residual returns if they occur are called variable interests. The initial determination of whether an entity is a variable interest entity shall be made on the date at which an enterprise becomes involved⁸ with the entity. That determination shall be based on the circumstances on that date including future changes that are required in existing governing documents and existing contractual arrangements. An enterprise is not required to determine whether an entity with which it is involved is a variable interest entity if it is apparent that the enterprise's interest would not be a significant variable interest and if the enterprise, its related parties, and its de facto agents (as described in paragraph 16) were not involved in forming the entity.

7. An entity that previously was not subject to this Interpretation shall not become subject to it simply because of losses in excess of its expected losses that reduce the equity investment. The initial determination of whether an entity is a variable interest entity shall be reconsidered only if one or more of the following occur:

- a. The entity's governing documents or the contractual arrangements among the parties involved change.

⁵For this purpose, the return to equity investors is not considered to be capped by the existence of outstanding stock options, convertible debt, or similar interests because if the options in those instruments are exercised, the holders will become additional equity investors.

⁶The term *investor* in this sentence includes the investor's related parties.

⁷This provision is necessary to prevent a primary beneficiary from avoiding consolidation of a variable interest entity by organizing the entity with nonsubstantive voting interests.

⁸For purposes of this Interpretation, involvement with an entity refers to ownership, contractual, or other pecuniary interests that may be determined to be variable interests.

- b. The equity investment or some part thereof is returned to the investors, and other parties become exposed to expected losses.
- c. The entity undertakes additional activities or acquires additional assets that increase the entity's expected losses.

Expected Losses and Expected Residual Returns

8. A variable interest entity's expected losses and expected residual returns shall include (a) the expected variability in the entity's net income or loss, (b) the expected variability in the fair value of the entity's assets (except as explained in paragraph 12) if it is not included in net income or loss, (c) fees to the decision maker (if there is a decision maker), and (d) fees to providers of guarantees of the values of all or substantially all of the entity's assets (including writers of put options and other instruments with similar results) and providers of guarantees that all or substantially all of the entity's liabilities will be paid.

9. An equity investment of less than 10 percent of the entity's total assets shall not be considered sufficient to permit the entity to finance its activities without subordinated financial support in addition to the equity investment unless the equity investment can be demonstrated to be sufficient in at least one of the following three ways:

- a. The entity has demonstrated that it can finance its activities without additional subordinated financial support.
- b. The entity has at least as much equity invested as other entities that hold only similar assets of similar quality in similar amounts and operate with no additional subordinated financial support.
- c. The amount of equity invested in the entity exceeds the estimate of the entity's expected losses based on reasonable quantitative evidence.

10. Some entities may require an equity investment greater than 10 percent of their assets to finance their activities, especially if they engage in high-risk activities, hold high-risk assets, or have exposure to risks that are not reflected in the reported amounts of the entities' assets or liabilities. The presumption in paragraph 9 does not relieve an enterprise of its responsibility to determine whether a particular entity with which the enterprise is involved needs an equity investment greater than 10 percent of its assets in order to finance its activities without subordinated financial support in addition to the equity investment.

Development Stage Enterprises

11. Because reconsideration of whether an entity is subject to this Interpretation is required only in certain circumstances, the initial application to an entity that is in the development stage⁹ is very important. A development stage entity is a variable interest entity if it meets the conditions in paragraph 5. A development stage entity does not meet the conditions in paragraph 5 if it can be demonstrated that the equity invested in the entity is sufficient to permit it to finance the activities it is currently engaged in (for example, if the entity has already obtained financing without additional subordinated financial support) and provisions in the entity's governing documents and contractual arrangements allow additional equity investments. However, sufficiency of the equity investment should be reconsidered as required by paragraph 7, for example, when the entity undertakes additional activities or acquires additional assets.

Variable Interests and Interests in Specified Assets of a Variable Interest Entity

12. A variable interest in specified assets of a variable interest entity (such as a guarantee or subordinated residual interest) shall be deemed to be a variable interest in the entity only if the fair value of the specified assets is more than half of the total fair value of the entity's assets or if the holder has another variable interest in the entity as a whole (except interests that are insignificant or have little or no variability).¹⁰ The expected losses and expected residual returns applicable to variable interests in specified assets of a variable interest entity shall be deemed to be expected losses and expected residual returns of the entity only if that variable interest is deemed to be a variable interest in the entity.

13. An enterprise with a variable interest in specified assets of a variable interest entity shall treat a portion of the entity as a separate variable interest entity if the specified assets (and related credit enhancements, if any) are essentially the only source of payment for specified liabilities or specified other interests.¹¹ That requirement does not apply unless the entity has been determined to be a variable interest entity. Expected losses related to specified assets are not considered part of the expected losses of the entity for purposes of determining the adequacy of the equity at risk in the entity

⁹Guidelines for identifying a development stage enterprise appear in paragraphs 8 and 9 of FASB Statement No. 7, *Accounting and Reporting by Development Stage Enterprises*.

¹⁰This exception is necessary to prevent an enterprise that would otherwise be the primary beneficiary of a variable interest entity from circumventing the requirement for consolidation simply by arranging for other parties with interests in certain assets to hold small or inconsequential interests in the entity as a whole.

¹¹The portions of a variable interest entity referred to in this paragraph have sometimes been called silos.

unless the specified assets constitute a majority of the assets of the entity. For example, expected losses of a guarantor of the residual value of leased property are not considered expected losses of a variable interest entity if the fair value of the leased property is not a majority of the fair value of the entity's total assets. If one enterprise is required to consolidate a discrete portion of a variable interest entity, other variable interest holders shall not consider that portion to be part of the larger variable interest entity.

Consolidation Based on Variable Interests

14. An enterprise shall consolidate a variable interest entity if that enterprise has a variable interest (or combination of variable interests) that will absorb a majority of the entity's expected losses if they occur, receive a majority of the entity's expected residual returns if they occur, or both. An enterprise shall consider the rights and obligations conveyed by its variable interests and the relationship of its variable interests with variable interests held by other parties to determine whether its variable interests will absorb a majority of a variable interest entity's expected losses, receive a majority of the entity's expected residual returns, or both. A direct or indirect ability to make decisions that significantly affect the results of the activities of a variable interest entity is a strong indication that an enterprise has one or both of the characteristics that would require consolidation of the variable interest entity. If one enterprise will absorb a majority of a variable interest entity's expected losses and another enterprise will receive a majority of that entity's expected residual returns, the enterprise absorbing a majority of the losses shall consolidate the variable interest entity.

15. The enterprise that consolidates a variable interest entity is called the primary beneficiary of that entity. An enterprise shall determine whether it is the primary beneficiary of a variable interest entity at the time the enterprise becomes involved with the entity. An enterprise with an interest in a variable interest entity shall reconsider whether it is the primary beneficiary of the entity if the entity's governing documents or the contractual arrangements among the parties involved change. The primary beneficiary also shall reconsider its initial decision to consolidate a variable interest entity if the primary beneficiary sells or otherwise disposes of all or part of its variable interest to unrelated parties. A holder of a variable interest that is not the primary beneficiary also shall reconsider whether it is the primary beneficiary of a variable interest entity if the enterprise acquires newly issued interests in the entity or a portion of the primary beneficiary's interest in the entity.

Related Parties

16. For purposes of determining whether it is the primary beneficiary of a variable interest entity, an enterprise with a variable interest shall treat variable interests in that same entity held by its related parties as its own interests. For purposes of this Interpretation, the term *related parties* includes those parties identified in FASB Statement No. 57, *Related Party Disclosures*, and certain other parties that are acting as de facto agents of the variable interest holder. The following are considered to be de facto agents of an enterprise:

- a. A party that cannot finance its operations without subordinated financial support from the enterprise, for example, another variable interest entity of which the enterprise is the primary beneficiary
- b. A party that received its interests as a contribution or loan from the enterprise
- c. An officer, employee, or member of the governing board of the enterprise
- d. A party that has (1) an agreement that it cannot sell, transfer, or encumber its interests in the entity without the prior approval of the enterprise or (2) a close business relationship like the relationship between a professional service provider and one of its significant clients.

17. If two or more related parties (including the de facto agents described in paragraph 16) hold variable interests in the same variable interest entity, and the aggregate variable interest held by those parties would, if held by a single party, identify that party as the primary beneficiary, the following guidelines shall be used for deciding which is the primary beneficiary:

- a. If two or more parties with variable interests have an agency relationship, the principal is the primary beneficiary.
- b. If the relationship is not that of a principal and an agent, the party with activities that are most closely associated with the entity is the primary beneficiary.

Initial Measurement

18. Except for enterprises under common control and assets and liabilities that are consolidated shortly after transfer from a primary beneficiary to a variable interest entity, the primary beneficiary of a variable interest entity shall initially measure the assets, liabilities, and noncontrolling interests of the newly consolidated entity at their fair values at the date the enterprise first becomes the primary beneficiary. That date is the first date on which, if the enterprise issued financial statements, it would report the entity in its consolidated financial statements.

19. The primary beneficiary of a variable interest entity that is under common control with the primary beneficiary shall initially measure the assets, liabilities, and noncontrolling interests of the variable interest entity at the amounts at which they are carried in the accounts of the enterprise that controls the variable interest entity (or would be carried if the enterprise issued financial statements prepared in conformity with generally accepted accounting principles).

20. The primary beneficiary of a variable interest entity shall initially measure assets and liabilities that it has transferred to that variable interest entity at the same amounts at which the assets and liabilities would have been measured if they had not been transferred. No gain or loss shall be recognized because of the transfer even if the enterprise was not the primary beneficiary until shortly after the transfer occurred.

21. The excess, if any, of the fair values of the newly consolidated assets and the reported amount of assets transferred by the primary beneficiary to the variable interest entity over the sum of the fair value of the consideration paid, the reported amount of any previously held interests, and the fair value of newly consolidated liabilities and noncontrolling interests shall be allocated and reported as a pro rata adjustment of the amounts that would have been assigned to all of the newly consolidated assets as specified in paragraphs 44 and 45 of FASB Statement No. 141, *Business Combinations*, as if the initial consolidation had resulted from a business combination. The excess, if any, of (a) the sum of the fair value of the consideration paid, the reported amount of any previously held interests, and the fair value of the newly consolidated liabilities and noncontrolling interests over (b) the fair value of the newly consolidated assets and the reported amount of assets transferred by the primary beneficiary to the variable interest entity shall be reported as an extraordinary loss in the period in which the enterprise becomes the primary beneficiary.

Accounting after Initial Measurement

22. The principles of consolidated financial statements in ARB 51 apply to primary beneficiaries' accounting for consolidated variable interest entities. After the initial measurement, the assets, liabilities, and noncontrolling interests of a consolidated variable interest entity shall be accounted for in consolidated financial statements as if the entity were consolidated based on voting interests. Any specialized accounting requirements applicable to the type of business in which the variable interest entity operates shall be applied as they would be applied to a consolidated subsidiary. The consolidated enterprise shall follow the requirements for elimination of intercompany balances and transactions and other matters described in paragraphs 6–15 of ARB 51 and existing practices for consolidated subsidiaries. Fees or other sources of income or expense between a primary beneficiary and a consolidated variable interest entity shall

be eliminated against the related expense or income of the variable interest entity, and the resulting net income or expense of the variable interest entity shall be attributed to the primary beneficiary (and not to noncontrolling interests) in the consolidated financial statements.

DISCLOSURE

23. In addition to disclosures required by other standards, the primary beneficiary of a variable interest entity shall disclose the following (unless the primary beneficiary also holds a majority voting interest):¹²

- a. The nature, purpose, size, and activities of the variable interest entity
- b. The carrying amount and classification of consolidated assets that are collateral for the variable interest entity's obligations
- c. Lack of recourse if creditors (or beneficial interest holders) of a consolidated variable interest entity have no recourse to the general credit of the primary beneficiary.

24. An enterprise that holds a significant variable interest in a variable interest entity but is not the primary beneficiary shall disclose:

- a. The nature of its involvement with the variable interest entity and when that involvement began
- b. The nature, purpose, size, and activities of the variable interest entity
- c. The enterprise's maximum exposure to loss as a result of its involvement with the variable interest entity.

25. Disclosures required by Statement 140 about a variable interest entity shall be included in the same note to the financial statements as the information required by this Interpretation. Information about variable interest entities may be reported in the aggregate for similar entities if separate reporting would not add material information.

¹²A variable interest entity may issue voting equity interests, and the enterprise that holds a majority voting interest may also be the primary beneficiary of the entity. If so, the disclosures in paragraphs 23 and 26 are not required.

EFFECTIVE DATE AND TRANSITION

26. If it is reasonably possible that an enterprise will consolidate or disclose information about a variable interest entity when this Interpretation becomes effective, the enterprise shall disclose the following information in all financial statements initially issued after January 31, 2003, regardless of the date on which the variable interest entity was created:

- a. The nature, purpose, size, and activities of the variable interest entity
- b. The enterprise's maximum exposure to loss as a result of its involvement with the variable interest entity.

27. All enterprises with variable interests in variable interest entities created after January 31, 2003, shall apply the provisions of this Interpretation to those entities immediately. A public entity¹³ with a variable interest in a variable interest entity created before February 1, 2003, shall apply the provisions of this Interpretation (other than the transition disclosure provisions in paragraph 26) to that entity no later than the beginning of the first interim or annual reporting period beginning after June 15, 2003. A nonpublic entity with a variable interest in a variable interest entity created before February 1, 2003, shall apply the provisions of this Interpretation (other than the transition disclosure provisions in paragraph 26) to that entity no later than the end of the first annual reporting period beginning after June 15, 2003.

28. If initial application of the requirements of this Interpretation results in initial consolidation of an entity created before February 1, 2003, the consolidating enterprise shall initially measure the assets, liabilities, and noncontrolling interests of the variable interest entity at their carrying amounts at the date the requirements of the Interpretation first apply. In this context, *carrying amounts* refers to the amounts at which the assets, liabilities, and noncontrolling interests would have been carried in the consolidated financial statements if the Interpretation had been effective when the enterprise first met the conditions to be the primary beneficiary. If determining the carrying amount is not practicable, the assets, liabilities, and noncontrolling interests of the variable interest entity shall be measured at fair value at the date the Interpretation first applies. Any difference between the net amount added to the balance sheet of the consolidating enterprise and the amount of any previously recognized interest in the newly consolidated entity shall be recognized as the cumulative effect of an accounting change.

¹³The terms *public entity* and *nonpublic entity* are defined in paragraph 395 of FASB Statement No. 123, *Accounting for Stock-Based Compensation*.

29. This Interpretation may be applied by restating previously issued financial statements for one or more years with a cumulative-effect adjustment as of the beginning of the first year restated. Restatement is encouraged but not required.

This Interpretation was adopted by the affirmative votes of six members of the Financial Accounting Standards Board. Mr. Foster dissented.

Consolidation standards throughout the world, including ARB 51 and Statement 94, are based on control. ARB 51 states, “There is a presumption that consolidated statements are more meaningful than separate statements and that they are usually necessary for a fair presentation when one of the companies in the group directly or indirectly has a controlling financial interest in the other companies.” The objective of this Interpretation is to assist in determining when one entity controls another entity in circumstances where control is difficult to discern, because either the structure of the variable interest entity obviates the need for decisions or control has been disguised. Mr. Foster does not believe this Interpretation consistently achieves that objective; rather, he believes that its application will in certain circumstances fail to identify the party that controls a variable interest entity and, instead, identify as the controlling party a party that does not control it. That, in turn, has the potential to result in entities not reporting in their consolidated financial statements assets that they control and liabilities for which they are obligated and to require different entities to report in their consolidated financial statements assets they do not control and liabilities for which they have no responsibility. He believes that is inappropriate because the FASB’s conceptual framework is clear that control is an essential characteristic of an asset and an obligation to sacrifice assets is an essential characteristic of a liability. Accordingly, he dissents from issuance of this Interpretation.

One concern is the Board’s conclusion that interests in transferred assets held by a transferor after it transfers assets to a variable interest entity can, in certain circumstances, be variable interests in that entity. Mr. Foster believes they are never variable interests; rather, he believes that a variable interest entity and a transferor of assets to that entity hold separate and distinct interests in the assets originally held by the transferor. For example, after a transfer of financial assets to a variable interest entity, the assets held by that entity can be characterized as strips—that is, they are contracts to receive designated cash flows from the transferred assets, often the first cash flows collected up to a designated amount or percentage of the contracted amount of the underlying assets. The transferor often holds the remaining interest in the cash flows—also a strip—and neither the creditors nor beneficial interest holders of the variable interest entity have recourse to those cash flows. The asset held by the transferor is not an interest in the variable interest entity at all; it is simply a separate and distinct interest in the same assets in which the variable interest entity has interests.

If the Board had concluded that shared interest in assets with a variable interest entity were not under any circumstances variable interests in the variable interest entity, Mr. Foster's overriding concern—that entities that control assets and owe liabilities have the potential to omit those assets and liabilities from their consolidated financial statements while other entities have the potential to report in their consolidated financial statements assets they do not control and liabilities for which they have no responsibility—would not arise. This Interpretation requires that variable interests held by a transferor of assets to a variable interest entity be considered in determining the primary beneficiary if a single transferor of assets to a variable interest entity transfers a majority of the assets held by that variable interest entity or if a transferor of assets to a variable interest entity has another variable interest in that entity as a whole. As a result, under this Interpretation, a transferor that transfers a majority of the assets held by a variable interest entity and retains an interest that will absorb virtually all of the potential losses of the original assets before they were divided likely would be required to consolidate the variable interest entity. However, if no party involved with the variable interest entity transfers a majority of the variable interest entity's assets, the interests of the transferors are not considered in determining the primary beneficiary. In that case, a party other than a transferor is likely to have the majority of the downside risk or upside potential of the variable interest entity and, thus, be the primary beneficiary. Consequently, two variable interest entities with identical structures, terms, and conditions, and that have the same entity making decisions about their activities may be consolidated by different parties, each of which has a substantially different relationship with the variable interest entity. One variable interest entity may be consolidated by a transferor with no decision-making ability if that transferor originally owned more than half of the assets in which the variable interest entity now has interests. Another essentially identical entity may be consolidated by the entity that has decision-making ability and rights and obligations related to the entity as a whole if no individual transferor holds interests in more than half of the assets in which the variable interest entity has interests. While Mr. Foster believes that an interest in assets in which a variable interest entity also has interests is not a variable interest, the Board has offered no rationale for ignoring transferors' variable interests in determining the primary beneficiary in circumstances in which a single transferor has not transferred a majority of the assets held by the variable interest entity. In his view, if the Board believes the interests held by a transferor of assets in which a variable interest entity also holds interests are variable interests, they should always be treated as variable interests or the Board should have a compelling rationale for why they are sometimes variable interests and sometimes not.

Mr. Foster believes that control is a matter of fact—it either exists or it does not—and that only one party can have control. The factors that result in an entity's ability to control a variable interest entity do not change simply because a majority of its assets are associated with assets originally held by a single transferor. Because this

Interpretation requires that factor to have the potential of being determinative as to which party is the primary beneficiary, Mr. Foster believes its application will sometimes fail to identify the entity that controls a variable interest entity. More important, in certain circumstances, it inappropriately requires consolidation of a variable interest entity by an entity that does not control it. As a result, even if one accepts that a transferor of a majority of the assets held by a variable interest entity still controls the transferred assets, if that transferor is determined to be the entity's primary beneficiary, that transferor will report in its consolidated financial statements assets and liabilities of the variable interest entity that result from transactions with other transferors—assets and liabilities for which it has no involvement and obligation to settle, respectively. Mr. Foster believes that is inappropriate regardless of the circumstances.

Members of the Financial Accounting Standards Board:

Robert H. Herz, *Chairman*
G. Michael Crooch
John M. Foster
Gary S. Schieneman
Katherine Schipper
Edward W. Trott
John K. Wulff

Appendix A

EXPECTED LOSSES, EXPECTED RESIDUAL RETURNS, AND EXPECTED VARIABILITY

A1. The following illustration of a computation of expected losses, expected residual returns, and expected variability is intended to explain the meaning of those terms. Enterprises will not necessarily be able to estimate probabilities to use a precise computation of the type illustrated, but they should use their best efforts to achieve the objective described. This illustration is based on a hypothetical pool of financial assets with total contractual cash flows of \$1 billion. The following assumptions have been made to simplify the illustration:

- a. A single party holds all of the beneficial interests in the entity, and the entity has no liabilities.
- b. There is no decision maker because the entity's activities are completely predetermined.
- c. All cash flows are expected to occur in one year or not to occur at all.
- d. The appropriate discount rate (the interest rate on risk-free investments) is 5 percent.
- e. No other factors affect the fair value of the assets. Thus, the present value of the expected cash flows from the pool of financial assets is assumed to be equal to the fair value of the assets.

A2. Table 1 shows the computation of expected cash flows using the cash flow possibilities that the variable interest holder has identified. The items to be included in expected cash flows of a variable interest entity are described in paragraph 8 of this Interpretation.

Table 1
(Amounts in Thousands)

<u>Estimated Cash Flows</u>	<u>Probability</u>	<u>Expected Cash Flows</u>	<u>Fair Value</u>
\$650,000	5.0%	\$ 32,500	\$ 30,952
700,000	10.0	70,000	66,667
750,000	25.0	187,500	178,571
800,000	25.0	200,000	190,477
850,000	20.0	170,000	161,905
900,000	15.0	135,000	128,571
	<u>100.0%</u>	<u>\$795,000</u>	<u>\$757,143</u>

The expected cash flows are \$795,000, and the fair value of the pool of assets is \$757,143.

A3. Table 2 shows how expected losses are computed once the expected cash flows are determined. Estimated cash flows (possible outcomes) are compared with the computed expected cash flows (probability weighted outcomes). Estimated cash flows that are less than the expected cash flows contribute to expected losses, and cash flow possibilities that exceed the expected cash flows contribute to expected residual returns.

Table 2
(Amounts in Thousands)

<u>Estimated Cash Flows</u> ¹⁴	<u>Expected Cash Flows</u>	Difference Estimated (Losses) Residual Returns	<u>Probability</u>	Expected Losses Based on Expected Cash Flows	Expected Losses Based on Fair Value
\$650,000	\$795,000	\$(145,000)	5.0%	\$ (7,250)	\$ (6,905)
700,000	795,000	(95,000)	10.0	(9,500)	(9,048)
750,000	795,000	(45,000)	25.0	(11,250)	(10,714)
800,000	795,000	5,000	25.0		
850,000	795,000	55,000	20.0		
900,000	795,000	105,000	15.0		
			<u>100.0%</u>	<u>\$(28,000)</u>	<u>\$(26,667)</u>

This Interpretation uses the term *expected losses* to refer to the expected losses based on fair value (using fair value as the benchmark), which in this illustration is \$26.667 million.

¹⁴The computation in this illustration uses estimated cash flows less expected cash flows times the probability and then discounts the result to arrive at fair value. The same result can be achieved by using the present value of the estimated cash flows less fair value times the probability. In situations in which the timing of the cash flows varies, that alternate form may be easier to use.

A4. Table 3 shows how expected residual returns are computed for the same pool of assets.

Table 3
(Amounts in Thousands)

<u>Estimated Cash Flows</u>	<u>Expected Cash Flows</u>	Difference Estimated (Losses) Residual Returns	<u>Probability</u>	Expected Residual Return Based on Expected Cash Flows	Expected Residual Return Based on Fair Value
\$650,000	\$795,000	\$(145,000)	5.0%		
700,000	795,000	(95,000)	10.0		
750,000	795,000	(45,000)	25.0		
800,000	795,000	5,000	25.0	\$ 1,250	\$ 1,191
850,000	795,000	55,000	20.0	11,000	10,476
900,000	795,000	105,000	15.0	15,750	15,000
			<u>100.0%</u>	<u>\$28,000</u>	<u>\$26,667</u>

This Interpretation uses the term *expected residual returns* to refer to the expected residual returns based on fair value (using fair value as the benchmark), which in this illustration is \$26.667 million. Expected variability is a measure of total variability in either direction. It is the sum of the absolute values of the expected losses and expected residual returns.

A5. This appendix uses a simple case intended to illustrate the concepts of expected losses, expected residual returns, and expected variability. Since it is assumed that there is only one party involved, the identity of the primary beneficiary is obvious. If different parties with different rights and obligations are involved, each party would determine its own expected losses and expected residual returns and compare that amount with the total to determine whether it is the primary beneficiary.

Appendix B

VARIABLE INTERESTS

B1. This appendix describes examples of different types of variable interests in entities subject to this Interpretation. It is not a complete list of all possible variable interests, and actual instruments may be more or less variable than the examples discussed. This discussion does not analyze the relative significance of each type of variable interest because each variable interest entity is different. That analysis must be based on all of the facts and circumstances in each situation.

Equity Investments, Beneficial Interests, and Debt Instruments

B2. Equity investments in a variable interest entity are variable interests to the extent they are at risk. (Equity investments at risk are described in paragraph 5 of this Interpretation.) Investments in subordinated beneficial interests¹⁵ or subordinated debt instruments issued by a variable interest entity also are variable interests. The holder of the most subordinated interest in an entity will absorb all or part of the expected losses of the entity. The return on that investment usually is a high interest rate or some form of participation in residual returns.

B3. Senior beneficial interests in variable interest entities and senior debt instruments with fixed interest rates or other fixed returns normally have little expected variability and usually would not, by themselves, make the holder the primary beneficiary of the issuer. Senior interests with variable rates of return have variability but normally still would not be sufficient to make the holder a primary beneficiary unless the subordinated interests of the variable interest entity are not large enough to absorb the entity's expected losses (or unless there are provisions such as embedded derivatives that expose the senior interests to losses). By definition, there are interests subordinated to the senior interests that will absorb losses first. Senior beneficial interests or senior debt instruments normally are not entitled to any of the residual returns if they occur.

¹⁵Paragraph 364 of Statement 140 defines beneficial interests as “rights to receive all or portions of specified cash inflows to a trust or other entity, including senior and subordinated shares of interest, principal, or other cash inflows to be ‘passed-through’ or ‘paid-through,’ premiums due to guarantors, commercial paper obligations, and residual interests, whether in the form of debt or equity.”

Guarantees, Written Put Options, and Similar Obligations

B4. Guarantees of the value of the assets or liabilities of a variable interest entity, written put options on the assets of the entity, or similar obligations that protect holders of senior interests from suffering losses are variable interests. A guarantee, written put option, or a similar interest is not an investment, but if it will be called on in the event expected losses occur, it is considered a variable interest. The size of the premium for issuing a guarantee or similar instrument is one indication of the amount of risk borne by the issuer. A rational provider of a guarantee would not be willing to take a significant risk of absorbing expected losses without a return at least commensurate with the risks of an equity investment. A lack of residual (equity-like) returns indicates that the risk of loss borne by the guarantor probably is not as high as the risk borne by an equity investor and, therefore, the guarantor is not likely to absorb a majority of the expected losses of the variable interest entity.

Forward Contracts

B5. A contract to purchase assets or equity securities from a variable interest entity or to sell assets or issue equity securities to a variable interest entity is a variable interest in that entity. However, if the contract price is either the market forward price at the date the contract is signed or the fair value at the date the exchange occurs, the variable interest may not be significant, and, therefore, the holder of the forward contract is not likely to absorb a majority of the expected losses of the variable interest entity or to receive a majority of the expected residual returns.

Other Derivative Interests and Compound Instruments

B6. Enterprises holding or writing swaps and other derivative instruments with variable interest entities should analyze those instruments by considering their option-like, forward-like, or other variable characteristics. By themselves, rights and obligations under derivative instruments with underlyings that are market interest rates or currency exchange rates probably will not cause the holder to be a primary beneficiary. However, instruments that include multipliers or similar leverage features can create significantly higher risks and returns, especially if the underlying of the derivative is a significant risk factor in the variable interest entity's activities or assets.

B7. Total return swaps and similar arrangements can be used to transfer substantially all of the risk or returns or both related to certain assets without actually transferring the assets. Possession of such an instrument issued by a variable interest entity is a strong indicator that the holder is the primary beneficiary.

Unconditional Liabilities to a Variable Interest Entity (Assets of the Variable Interest Entity)

B8. A fixed and unconditional liability owed to a variable interest entity is not a variable interest in that entity because it is not variable. A variable rate liability owed to a variable interest entity is a variable interest. However, if the rate varies according to an interest rate index or a similar market benchmark and there are no leverage factors or other significant embedded derivatives, variable rate liabilities, by themselves, are not likely to make the obligor a primary beneficiary.

Service Contracts

B9. Contracts for services may be significant variable interests if the contracted compensation (whether fixed or variable) is designed to be different from the market value of the services provided. A service contract also can be important in identifying a primary beneficiary if that contract permits the holder to make decisions about the activities of a variable interest entity because fees paid to a decision maker are included in the expected residual returns of the entity.

Leases

B10. Long-term leases with a variable interest entity are not considered in determining the primary beneficiary of that variable interest entity if the lease terms are consistent with market terms at the inception of the lease and the lease does not include a residual value guarantee or similar feature. In that situation, the expected losses and expected residual returns of the lessee are equal to each other and are no greater than the aggregate expected losses and expected residual returns of the investors, lenders, and other parties with interests in the lease.

Variable Interests of One Variable Interest Entity in Another Variable Interest Entity

B11. One variable interest entity is the primary beneficiary of another variable interest entity if it meets the conditions in paragraph 14. If one variable interest entity is the primary beneficiary of a second variable interest entity, it consolidates that second variable interest entity. If another party consolidates the first variable interest entity, that party's consolidated financial statements include the second variable interest entity because the second entity had already been consolidated by the first. For example, if Entity X (a variable interest entity) is the primary beneficiary of Entity Y (a variable

interest entity), Entity X consolidates Entity Y. If Enterprise Z is the primary beneficiary of Entity X, Enterprise Z consolidates Entity X, and Enterprise Z's consolidated financial statements include Entity Y because Entity X has consolidated Entity Y.

B12. A retained interest of a transferor of financial assets to a variable interest entity is a variable interest in the transferee entity but is not a variable interest in a second variable interest entity to which the transferee issues a beneficial interest. The following example illustrates the point:¹⁶

- a. Enterprise A transfers financial assets to Entity 1 (a variable interest entity that holds no other assets), retains a subordinated beneficial interest, and reports the transfer as a sale under the provisions of Statement 140.
- b. Entity 1 issues all of its senior beneficial interests in the transferred assets to Entity 2 (a variable interest entity). Entity 2 issues various types of interests in return for cash and uses the cash to pay Entity 1. Entity 1 uses the cash received from Entity 2 to pay Enterprise A.
- c. Enterprise A's subordinated beneficial interest is a variable interest in Entity 1, but neither Entity 1 nor Enterprise A has a variable interest in Entity 2.

¹⁶This analysis describes variable interests in all variable interest entities including qualifying special-purpose entities. However, a special requirement applies to qualifying special-purpose entities. Refer to paragraph 4(c) and (d).

Appendix C

BACKGROUND INFORMATION AND BASIS FOR CONCLUSIONS

CONTENTS

	Paragraph Numbers
Introduction.....	C1
Background.....	C2–C4
Objective of This Interpretation.....	C5–C7
Scope	C8–C17
Variable Interest Entities.....	C18–C25
Expected Losses and the 10 Percent Presumption	C21–C25
Application to Selected Assets and Variable Interests in a Majority of a Variable Interest Entity’s Assets	C26–C28
Primary Beneficiaries	C29–C37
Related Parties	C38–C41
Special Provisions for Certain Entities in the Proposed Interpretation.....	C42–C44
Initial Measurement and Subsequent Accounting.....	C45–C46
Disclosure Requirements	C47–C48
Effective Date and Transition	C49–C50

Appendix C

BACKGROUND INFORMATION AND BASIS FOR CONCLUSIONS

Introduction

C1. This appendix summarizes considerations that Board members deemed significant in reaching the conclusions in this Interpretation. It includes reasons for accepting certain views and rejecting others. Individual Board members gave greater weight to some factors than to others.

Background

C2. Various EITF Issues, SEC staff announcements, and FASB pronouncements address issues that directly or indirectly relate to variable interest entities, but most are applicable only to a single type of variable interest entity. The effects of this Interpretation on EITF Issues are summarized in Appendix D. No FASB pronouncements are amended or superseded by this Interpretation.

C3. The Board issued the proposed Interpretation, *Consolidation of Certain Special-Purpose Entities*, in July 2002, and received over 140 letters of comment from constituents. On September 30, 2002, the Board held 2 public roundtable meetings at which approximately 40 respondents and other interested parties discussed the provisions of the proposed Interpretation with the Board. This Interpretation is the result of the Board's redeliberation of all of the issues in light of the comments received on the proposed Interpretation.

C4. The proposed Interpretation referred to the entities subject to its requirements as special-purpose entities and used the term *substantive operating enterprises* to describe business enterprises other than special-purpose entities. However, that terminology confused many constituents apparently because the term *special-purpose entity* has been used without being clearly defined. As a result, this Interpretation refers to entities subject to its requirements as *variable interest entities*.

Objective of This Interpretation

C5. The objectives of this Interpretation are to explain how to identify variable interest entities and how to determine when a business enterprise should include the assets, liabilities, noncontrolling interests, and results of activities of a variable interest entity in its consolidated financial statements. Transactions involving variable interest entities

have become increasingly common, and the existing accounting literature is fragmented and incomplete. Some enterprises have entered into arrangements using variable interest entities that appear to be designed to avoid reporting assets and liabilities for which they are responsible, to delay reporting losses that have already been incurred, or to report gains that are illusory. At the same time, many enterprises have used variable interest entities for valid business purposes and have properly accounted for those entities based on guidance and accepted practice prior to this Interpretation.

C6. The traditional reason for including two or more enterprises in consolidated financial statements, as described in ARB 51, is that consolidated financial statements are “usually necessary for a fair presentation when one of the companies in the group directly or indirectly has a controlling financial interest in the other companies.” ARB 51 states further that “the usual condition for a controlling financial interest is ownership of a majority voting interest. . . .” Prior to this Interpretation, the accounting guidance related to variable interest entities has been limited in scope and application.

C7. Some relationships between business enterprises and variable interest entities are similar to relationships established by majority voting interests, but variable interest entities often are arranged without a governing board or with a governing board that has limited ability to make decisions that affect the entity’s activities. A variable interest entity’s activities may be limited or predetermined by the articles of incorporation, bylaws, partnership agreements, trust agreements, other establishing documents, or contractual agreements between the parties involved with the entity. An enterprise implicitly chooses at the time of its investment to accept the activities in which the variable interest entity is permitted to engage. That enterprise may not need the ability to make decisions if the activities are predetermined or limited in ways the enterprise chooses to accept. Alternatively, the enterprise may obtain an ability to make decisions that affect a variable interest entity’s activities through contracts or the entity’s governing documents. There may be other techniques for protecting an enterprise’s interests. In any case, the enterprise may receive benefits similar to those received from a controlling financial interest and be exposed to risks similar to those received from a controlling financial interest without holding a majority voting interest (or without holding any voting interest). Risks, benefits, or both are the determinants of consolidation in this Interpretation. The ability to make decisions is considered an indication that an enterprise may have sufficient benefits and risks to require consolidation.

Scope

C8. This Interpretation generally applies to business enterprises and arrangements used by business enterprises. ARB 51 refers to “companies” and FASB Statement No. 94, *Consolidation of All Majority-Owned Subsidiaries*, which amends ARB 51, refers only to “business enterprises.” The Board considered it inappropriate to extend the requirements of this Interpretation to not-for-profit organizations because the document being interpreted does not specifically apply to them. The Board is aware that some of the requirements in ARB 51 are applied in modified forms to certain not-for-profit organizations and does not intend this Interpretation to cause a change in those practices.

C9. The scope of the Interpretation also excludes certain arrangements that could be considered entities as the term is described in paragraph 3. Paragraph 46 of Statement 140 specifically prohibits consolidation by a transferor or its affiliates of qualifying special-purpose entities (including formerly qualifying SPEs described in paragraph 25 of that Statement). That prohibition was specifically intended to exclude those special-purpose entities from future Board decisions about consolidations. The derecognition requirements in Statement 140 are based on control of assets, and reporting of an enterprise’s rights and obligations related to financial assets that have been transferred and derecognized is based on a financial components approach. Because a qualifying special-purpose entity has such limited decision-making abilities, the Board decided that retention of the financial components approach for parties involved with a qualifying special-purpose entity was more appropriate than consolidation based on variable interests. Therefore, this Interpretation does not change that requirement.

C10. This Interpretation also includes a special provision related to enterprises other than transferors and their affiliates that are involved with qualifying special-purpose entities and formerly qualifying SPEs. No enterprise is required to consolidate a qualifying special-purpose entity or formerly qualifying SPE unless that enterprise has the unilateral ability to cause the entity to liquidate or to change the entity so that it no longer meets the conditions in paragraph 25 or 35 of Statement 140.

C11. Separate accounts of life insurance enterprises are excluded from the scope of this Interpretation because existing accounting standards specifically require life insurance enterprises to recognize those accounts and the Board chose not to change those requirements without a broader reconsideration of accounting by insurance enterprises.

C12. Paragraph 3 of this Interpretation specifies that so-called virtual SPEs (divisions, departments, branches, or pools of assets subject to liabilities that are otherwise nonrecourse to the enterprise) are excluded from the scope of this Interpretation

because they are not separate legal structures from the enterprise that holds title to the assets. That exception is narrower than the exception in the proposed Interpretation. The proposed Interpretation would have prohibited a primary beneficiary from consolidating a variable interest entity if the entity were consolidated by a substantive operating enterprise¹⁷ with a majority voting interest in the variable interest entity. The Board included that provision to avoid treating similar arrangements differently. For example, a lessor enterprise may have a choice of how to structure a lease. It may own leased assets directly and obtain a loan with recourse only to the leased property. Alternatively, the lender may require the lessor enterprise to establish a separate legally isolated entity to hold the leased assets. That separate entity is likely to be so thinly capitalized that it would be a variable interest entity. If so, the entity might have been consolidated by a party other than the lessor enterprise, depending on the lease terms, even though a party other than the lessor enterprise would never consolidate the asset if the lessor enterprise held it directly. The so-called substantive operating enterprise exception was intended to prevent different reporting results for two arrangements with little economic difference.

C13. Some respondents supported the exception in the proposed Interpretation. Other respondents stated that the prohibition created an artificial distinction between entities based on the identity of the equity investors. Lessees would have been able to avoid consolidating an entity by finding an enterprise that is not concerned about its balance sheet and paying it to make a small investment in return for 100 percent of the stock of a lessor entity. The Board had to choose between two possible outcomes, either of which could be viewed as undesirable. One possible outcome was to permit different accounting results depending on whether a variable interest entity was used in a particular arrangement, and the other possible outcome was to permit different accounting results depending on the identity of the equity investor.

C14. The Board eliminated the substantive operating enterprise exception because proper application of the variable interest requirements in the Interpretation will identify the equity investor as the primary beneficiary if the equity investor has a majority of the exposure to expected losses and rights to residual returns. For example, if the sole equity investor in a lessor entity has an equity investment smaller than required in paragraph 5 of this Interpretation, that entity will be a variable interest entity. If the investor meets the requirements in paragraph 14, it will be the primary beneficiary. Also, the subject of this Interpretation is consolidation of entities. Attempting to deal with derecognition of assets and liabilities that are not in a separate entity is beyond the scope of the Interpretation.

¹⁷The proposed Interpretation defined a substantive operating enterprise as an entity other than an SPE.

C15. A few respondents requested that the Board provide an exception for privately held businesses under common control. Two reasons cited were (a) users of financial statements do not consider private businesses to be special-purpose entities and (b) some enterprises under common control are already included in combined financial statements but measured on the same basis as they are measured in the separate financial statements. The proposed Interpretation would have required that they be remeasured at fair value as of the date its requirements were first applied.

C16. The Board decided not to accommodate those requests for two reasons. First, the Board believes that if privately held businesses have the characteristics of variable interest entities, the accounting and reporting requirements in this Interpretation are appropriate. Second, the Board decided not to require fair value measurement if a variable interest entity is under common control with its primary beneficiary.

C17. Several respondents requested exceptions for certain leasing arrangements, but the Board decided against making those exceptions. Although this Interpretation may change the accounting for certain leasing arrangements involving variable interest entities, it does not amend any FASB Statements or Interpretations on lease accounting. The possible changes in accounting are the result of treating a variable interest entity involved in a leasing arrangement as part of the same consolidated reporting entity as one of the other parties involved in the arrangement.

Variable Interest Entities

C18. Variable interest entities often are created for a single specified purpose, for example, to facilitate securitization, leasing, hedging, research and development, reinsurance, or other transactions or arrangements. The activities may be predetermined by the documents that establish the entities or by contracts or other arrangements between the parties involved. However, those characteristics do not define the scope of this Interpretation because other business enterprises may have those same characteristics. The distinction between variable interest entities and other business enterprises is based on the nature and amount of the equity investment and the rights and obligations of the equity investors.

C19. Because the equity investors in an enterprise other than a variable interest entity generally absorb losses first, they can be expected to resist arrangements that give other parties the ability to significantly increase their risk or reduce their benefits. Other parties can be expected to align their interests with those of the equity investors, protect their interests contractually, or avoid any involvement with the enterprise.

C20. In contrast, either a variable interest entity does not issue voting interests (or other interests with similar rights) or the total equity investment at risk is not sufficient to permit the entity to finance its activities without additional subordinated financial support. If an entity does not issue voting or similar interests or if the equity investment is insufficient, that entity's activities probably are predetermined or decision-making ability is determined contractually. If the total equity investment at risk is not sufficient to permit the entity to finance its activities, the parties providing the necessary additional subordinated financial support will not permit an equity investor to make decisions that may be counter to their interests. That means that the usual condition for establishing a controlling financial interest—a majority voting interest—does not apply to variable interest entities. Consequently, a standard for consolidation that requires ownership of voting stock or some other form of decision-making ability is not appropriate for such entities.

Expected Losses and the 10 Percent Presumption

C21. The Board selected expected losses as the benchmark for determining how much equity must be invested in an entity in order to induce lenders or other investors to provide the funds necessary for the entity to conduct its activities. The Board was unable to identify a method in general use for determining when an entity's equity is sufficient to permit the entity to finance its activities. Lenders and rating agencies with which the Board and its staff discussed the matter do not all use the same methodologies, but the methodologies incorporate historical experience with similar entities or with similar assets. Many adjust the historically determined amount for expectations about the specific entity and the current economic conditions. Those methods are generally consistent with the concept of expected losses, but they may result in requiring an equity investment greater than expected losses. That is, lenders and others want to be protected in the event actual losses exceed the expected losses, and they will negotiate as much protection as possible. Consequently, sufficient equity for financing is probably greater than expected losses and is unlikely to be less.

C22. Some respondents to the proposed Interpretation stated that *expected losses* is not the appropriate basis for determining how much equity an enterprise needs to finance its activities. However, there was no consensus on what the appropriate basis is. Some alternatives suggested were most likely losses (a point estimate), probable losses, reasonably possible losses, and maximum possible losses, but respondents generally did not provide a rationale for any of those measures. In many cases, maximum losses would equal the total assets of the entity. Most of the other measures would be smaller in many cases than expected losses.

C23. Because precisely estimating expected losses may be difficult and an entity may need an equity investment greater than its expected losses, the Board established a presumption that an equity investment is insufficient to allow an entity to finance its activities unless the investment is equal to at least 10 percent of the entity's total assets. Another reason for that presumption is to emphasize that the requirement for 3 percent equity referred to in EITF Issue No. 90-15, "Impact of Nonsubstantive Lessors, Residual Value Guarantees, and Other Provisions in Leasing Transactions," is superseded and that an equity investment as small as 3 percent is insufficient for many variable interest entities. The Board intends that presumption to apply in one direction only. That is, an equity investment of less than 10 percent is presumed to be insufficient, but an equity investment of 10 percent is not presumed to be sufficient.

C24. The Board's preferred methods of overcoming the 10 percent presumption are to demonstrate the sufficiency of the invested equity by (a) obtaining financing without additional subordinated financial support or (b) referring to the equity invested in another similar-sized entity with similar assets, liabilities, and other interests that has financed itself without additional subordinated financial support. However, many respondents to the proposed Interpretation stated that finding comparable entities would be difficult for some variable interest entities. The Board acknowledged that concern and decided to permit comparison of an entity's equity investment to an estimate of the entity's expected losses based on objective evidence about the entity's nature and the economic conditions at the time of the estimate.

C25. Some respondents recommended that the Board use the criteria for identifying a business in EITF Issue No. 98-3, "Determining Whether a Nonmonetary Transaction Involves Receipt of Productive Assets or of a Business," to identify entities that are not subject to this Interpretation. The Board did not accept that recommendation because those criteria were designed for a different purpose—to distinguish between businesses and groups of assets. That distinction is not related to control by voting interests or sufficiency of equity investments, which are the key issues in this Interpretation.

Application to Selected Assets and Variable Interests in a Majority of a Variable Interest Entity's Assets

C26. Paragraph 3 of this Interpretation does not permit an enterprise to consolidate selected assets or liabilities of a business enterprise that is not a variable interest entity. The stockholders or other parties that individually or in the aggregate have a controlling financial interest in the enterprise provide the subordinated financial support for the entity as a whole. However, variable interest entities can be structured so that the rights and obligations of different parties involved are not commingled. Consequently, a single variable interest entity may hold assets transferred by more than one enterprise,

leased to more than one enterprise, guaranteed by more than one enterprise, or similarly related to more than one enterprise. Those enterprises may have variable interests in selected assets instead of variable interests in the entities that hold those assets. The Board decided that if the liabilities or other interests in those assets apply only to those assets (with no recourse to the entity as a whole), it is appropriate for each enterprise to consider that discrete portion of the variable interest entity as a separate entity. That requirement is reflected in paragraph 13 of this Interpretation.

C27. Paragraph 12 addresses variable interests in specified assets of a variable interest entity that are not associated with a discrete portion of the variable interest entity's liabilities or other interests. The issues are (a) when, if ever, the expected losses of a party with a variable interest in specified assets of a variable interest entity are considered expected losses of the entity for purposes of determining whether an entity is a variable interest entity (the sufficiency of its equity) and (b) which parties hold variable interests in the entity as a whole for purposes of identifying the primary beneficiary of the entity. Some Board members concluded that any variable interest in specified assets of a variable interest entity is a variable interest in the entity regardless of the significance of those assets to the variable interest entity. Other Board members concluded that a variable interest in specified assets of a variable interest entity is a variable interest in the entity only if the interest applies to substantially all of the variable interest entity's assets. Board members also considered whether variable interests in specified assets of a variable interest entity might be variable interests in the entity in some circumstances and not in others.

C28. No alternative was supported by a majority of Board members, and, consequently, the Board members accepted a compromise. If the fair value of assets in which a party has a variable interest constitutes a majority of the fair value of a variable interest entity's total assets, that interest is considered significant enough that the holder is considered to have a variable interest in the entity. If the assets are less than a majority, the party does not have a variable interest in the entity unless that party also has more than an insignificant variable interest in the entity as a whole. That majority requirement is intended to prevent a transferor from avoiding the consolidation requirements by finding or creating a variable interest entity that commingles its transferred assets with a relatively few unrelated assets. At the same time, it should not prevent a decision maker with a sufficiently large variable interest in a so-called multi-seller variable interest entity from consolidating that entity because transferors of assets to a variable interest entity retain subordinated residual interests in certain of the transferred assets. The requirement to consider a variable interest in specified assets as an interest in the entity as a whole only if the holder has other interests in the entity as a whole that are not insignificant also is intended to prevent circumvention of the requirements of this document by artful allocation of variable interests.

Primary Beneficiaries

C29. Under ARB 51, a majority voting interest is considered sufficient evidence of a controlling financial interest to require consolidation. However, because variable interest entities are organized differently from many other enterprises, equity investors in variable interest entities may not have the same types of rights and obligations as equity investors in other enterprises. Some other party or parties may absorb the expected losses if the entity does not generate sufficient cash flows or income to provide the expected returns to all parties or may receive expected residual returns if cash flows are more than sufficient to provide all of the expected returns. A holder of an interest or combination of interests (other than voting equity interests) that absorbs expected losses or receives expected residual returns of a variable interest entity may have a controlling financial interest in that variable interest entity (or a relationship sufficiently similar to a controlling financial interest that it requires consolidation).

C30. The requirements in paragraph 14 of this Interpretation are intended to determine which, if any, party involved with a variable interest entity has a controlling financial interest in that entity. That paragraph focuses on three characteristics that are present in controlling financial interests achieved through majority voting interests:

- a. The ability to make decisions about an entity's activities
- b. The exposure to the expected losses of the entity if they occur
- c. The right to receive the expected residual returns of the entity if they occur.

C31. The ability to make decisions is not a variable interest, but if the decisions significantly affect the value of the variable interests, decision making will almost certainly be directly or indirectly associated with the holder of a significant variable interest. For that reason, decision making is an indicator of the primary beneficiary of a variable interest entity. A majority of either the exposure to expected losses or the right to receive expected residual returns (or both) identifies the primary beneficiary. The Board considered the exposure to losses to be the more important of the two conditions and established it as the more important factor if one enterprise has a majority of the exposure to expected losses and another has a right to a majority of the residual returns.

C32. The proposed Interpretation would have required identification of the primary beneficiary based primarily on financial support (exposure to expected losses through variable interests). Many respondents commented that the analogy to voting equity investments is incomplete without consideration of expected residual returns. Those comments persuaded the Board to add a requirement to consolidate if an enterprise has the right to a majority of a variable interest entity's expected residual returns.

C33. Some respondents recommended alternatives to consolidation by a primary beneficiary. One recommendation was to require all enterprises to report interests in variable interest entities at fair value instead of requiring any enterprise to consolidate. The Board did not accept the recommendation because there are many instances in which an enterprise's interest is represented more faithfully by a gross presentation of assets and liabilities.

C34. Many other respondents recommended that the Board accumulate the existing guidance on consolidation of variable interest entities in a single standard without changing that guidance other than to require additional disclosures. The Board decided that the existing standards are not only fragmented (which this suggestion would address) but also inadequate (which it would not address except by disclosure). Moreover, additional disclosures are not a replacement for proper recognition and measurement.

C35. The proposed Interpretation would have required consolidation of a variable interest entity by an enterprise that provided significant financial support to that variable interest entity through a variable interest if that support was significantly more than the support provided by any other individual party. It also would have required consolidation by an enterprise that provided the majority of the financial support of a variable interest entity. Many respondents argued that an enterprise should consolidate a variable interest entity only if the enterprise provides a majority of the financial support to that entity. Some of those respondents stated that the reason was conceptual; others stated that the reason was practical, that is, it would be easier to apply a majority requirement. In some cases, the majority requirement will be applied qualitatively because the variable interests in an entity may be so different in nature that there is no common basis on which to compare them arithmetically. An enterprise may be able to determine without detailed computations that it does not have a sufficiently large variable interest to be a potential primary beneficiary or that it is the only enterprise with a sufficiently large interest. In other cases, an enterprise may know that it is one of only a few potential primary beneficiaries and may need to apply judgment to determine whether it meets the conditions to be a primary beneficiary.

C36. The Board acknowledged in the proposed Interpretation that an entity's variable interest takes on decreased significance as its absolute size diminishes but noted that a parent has never been required to have a majority of risks or returns from activities of its subsidiary in order to consolidate that subsidiary. Thus, the significance requirement would not necessarily have been conceptually inappropriate. However, the Board was persuaded that enterprises might not be able to apply the *significant and significantly more* requirement consistently. Consequently, that requirement has been eliminated in this Interpretation.

C37. The proposed Interpretation also would have required each enterprise involved with a variable interest entity to reconsider at each reporting date whether it was the primary beneficiary. Many respondents stated that variable interests should not be reassessed or should be reassessed only if a triggering event occurs because the necessary information may not be available or would be burdensome to acquire. The Board agreed and decided to require reconsideration only if certain events occur that are likely to cause a change in the primary beneficiary.

Related Parties

C38. An enterprise and its affiliates, managers, agents, and other related parties may work as a group to establish and manage a variable interest entity even if no single party in the group meets the conditions in paragraph 14 of this Interpretation. Paragraph 16 includes a provision intended to prevent a variable interest holder from avoiding consolidation of a variable interest entity by arranging to protect its interest or indirectly expand its holdings through other parties.

C39. This Interpretation treats certain parties in addition to those identified in Statement 57 as related parties of a variable interest holder. Those other parties (a) are financially dependent on a variable interest holder, (b) cannot sell, transfer, or encumber their interests without the approval of a variable interest holder, (c) receive the investment or the funds to make the investment from a variable interest holder, or (d) provide significant amounts of professional services or other similar services to a variable interest holder. Those parties are considered to be acting as *de facto* agents of the variable interest holder.

C40. Many respondents to the proposed Interpretation stated that either the term *de facto agency relationship* should be defined in more detail or the provision should be eliminated. The Board did not believe that was necessary because the Interpretation describes the parties that are to be considered *de facto* agents in sufficient detail.

C41. Other respondents to the proposed Interpretation stated that related parties should specifically include employees and directors. The Board agreed, and those parties have been added to paragraph 16.

Special Provisions for Certain Entities in the Proposed Interpretation

C42. The Board recognizes that some variable interest entities effectively disperse risks and benefits related to their assets or activities. No individual party controls the benefits of the variable interest entity's assets or is responsible for the variable interest

entity's liabilities. In that case, each party involved should account for its rights and obligations related to the assets in the variable interest entity, but it is inappropriate for any party to consolidate the assets and liabilities of the variable interest entity.

C43. To emphasize that point, the proposed Interpretation included special provisions for analyzing variable interest entities that hold certain financial assets, have limits on their activities and the interests they can issue, and are legally isolated from the enterprises that hold interests in them. The Board recognized that even if an entity is designed to disperse risks and returns among different interests, a single enterprise could recombine those dispersed risks and returns by acquiring enough different variable interests. Therefore, the special provisions included requirements for consolidation by a party with any two of three characteristics—the ability to decide when a variable interest entity buys and sells assets, an obligation to absorb losses, and the right to fees that are not based on the market price of the services provided.

C44. Many respondents to the proposed Interpretation agreed that special provisions for certain variable interest entities were appropriate but stated that the criteria to qualify for the special provisions were too restrictive. Respondents also stated that the special provisions would require consolidation more frequently than the general variable interest requirements. The Board did not intend for the special provisions to conflict with the general requirements. In addition, it became apparent that the special provisions would need significant interpretation and maintenance. Consequently, the Board decided to eliminate the special provisions. The Board believes that the general requirements properly reflect the effect of risk dispersion and that special provisions for a subset of variable interest entities are unnecessary.

Initial Measurement and Subsequent Accounting

C45. Statement 141 specifies the initial measurement requirements for net assets that constitute a business and for assets, liabilities, and noncontrolling interests of newly acquired subsidiaries. Newly consolidated variable interest entities are not subject to Statement 141 because paragraph 9 of Statement 141 states, "This Statement does not address transactions in which control is obtained through means other than an acquisition of net assets or equity interests." A primary beneficiary of a variable interest entity has not obtained control through equity interests, and it has not purchased net assets. However, the Board decided that many of the initial measurement requirements of Statement 141 are appropriate for variable interest entities consolidated for the first time (except at transition). One exception is that goodwill is not recognized. The difference, if any, between the reported amounts of the variable interest entity's assets and the reported amounts of its liabilities and noncontrolling interests is recognized in consolidated net income if that difference results in a loss. Many variable interest

entities hold either financial assets or newly acquired assets, and the Board did not believe it would be appropriate to allocate a loss to increase the reported values of those assets over their fair values. If recognizing the newly consolidated assets, liabilities, and noncontrolling interests would otherwise result in a gain, that amount is required to be allocated as if the consolidation resulted from a business combination. That provision is intended to prevent intentional creation of a gain by arranging to become the primary beneficiary of a carefully structured entity, especially if the entity's assets are difficult to measure.

C46. The proposed Interpretation did not include specific guidance on subsequent accounting for consolidated variable interest entities because the Board expected that enterprises would apply consolidation policies applicable to subsidiaries. Many respondents requested that the Board specify certain requirements. For example, one suggestion was to require financial assets and liabilities to be reported at fair value. However, the Board decided that the subsequent accounting for consolidated variable interest entities should be no different from the accounting that would apply to a majority-owned subsidiary engaged in the same activities.

Disclosure Requirements

C47. Respondents to the proposed Interpretation requested an extensive list of specific disclosures by primary beneficiaries, many of which were similar to the disclosures required by Statement 140. The Board judged that the cost to enterprises to prepare all of the requested information for disclosure would have been prohibitive and that some of the information would be valuable only to a limited number of users. Consequently, after discussions with various constituents, the Board identified the disclosures it believes will be most useful to the greatest number of financial statement users without imposing too great a cost on the issuers of financial statements.

C48. The proposed Interpretation would have required certain disclosures by enterprises that provide significant administrative services to a variable interest entity. Respondents stated that the disclosure requirement should apply only to entities with significant variable interests. The Board believes that information about variable interest entities in which an enterprise has significant variable interests is of interest to users whether or not the enterprise is the administrator of the entity and decided to base the requirement on a significant variable interest.

Effective Date and Transition

C49. The Board believes that the requirements of this Interpretation should be effective as soon as reasonably possible. However, the Board also recognizes that some enterprises are involved with large numbers of variable interest entities and that their analyses of variable interests will require significant data gathering and qualitative and quantitative analysis. In addition, the transition period originally proposed would have included the period in which many enterprises were preparing calendar-year financial statements. Therefore, the Board decided to defer the required application date of this Interpretation to existing variable interest entities to three months later than the date in the proposed Interpretation. However, in the interest of providing financial statement users with information about existing variable interest entities as soon as possible, the Board decided to require transition disclosures to be made almost immediately.

C50. The proposed Interpretation would have required measurement of the assets, liabilities, and noncontrolling interests of a newly consolidated variable interest entity at their fair values, primarily because the Board believed information about carryover bases for most entities would not be available. However, many respondents stated that they would be able to determine carryover basis and requested that the Board permit its use. Consequently, the Board decided that measurement at transition should be at carryover basis unless it is impracticable, in which case fair value measurement would be required.

Appendix D

EFFECT OF THIS INTERPRETATION ON EITF ISSUES

D1. The provisions of this Interpretation nullify the consensus in the following EITF Issue and the guidance in the following EITF Topic:

- a. Issue No. 90-15, “Impact of Nonsubstantive Lessors, Residual Value Guarantees, and Other Provisions in Leasing Transactions”

The Task Force indicated that a lessee is required to consolidate an SPE lessor at the inception of a lease if (1) substantially all of the activities of the SPE involve assets that are to be leased to a single lessee, (2) the expected substantive residual risks and substantially all the residual rewards of the leased assets and the obligation imposed by the underlying debt of the SPE reside directly or indirectly with the SPE, and (3) the owners of record of the SPE have not made an initial substantive residual equity capital investment that is at risk during the entire term of the lease. The SEC staff’s answer to Question No. 3 states, in part: “The SEC staff understands from discussions with Working Group members that those members believe that 3 percent is the minimum acceptable investment. The SEC staff believes a greater investment may be necessary depending on the facts and circumstances, including the credit risk associated with the lessee and the market risk factors associated with the leased property.”

Those requirements are nullified by this Interpretation. If a lessor entity is a variable interest entity as described in this Interpretation, it is subject to consolidation based on the provisions of this Interpretation. If a lessor entity is not a variable interest entity, it is subject to the requirements of ARB 51 as amended by FASB Statement No. 94, *Consolidation of All Majority-Owned Subsidiaries*.

- b. Topic No. D-14, “Transactions involving Special-Purpose Entities”

The SEC Observer noted that the SEC staff believes that nonconsolidation and sales recognition are not appropriate by the sponsor or transferor of an SPE when the majority owner of the SPE makes only a nominal capital investment, the activities of the SPE are virtually all on the sponsor’s or transferor’s behalf, and the substantive risks and rewards of the assets or the debt of the SPE rest directly or indirectly on the sponsor or transferor.

That requirement is nullified by this Interpretation. If an SPE is a variable interest entity as described in this Interpretation, it is subject to consolidation based on the provisions of this Interpretation. If an SPE is not a variable interest entity, it is subject to the requirements of ARB 51 as amended by Statement 94.

D2. The provisions of this Interpretation modify or partially nullify the consensus in the following EITF Issues:

- a. Issue No. 95-6, “Accounting by a Real Estate Investment Trust for an Investment in a Service Corporation”

Task Force members agreed that the determination of whether a real estate investment trust should consolidate a service corporation should be based on the facts and circumstances.

This Interpretation nullifies that consensus for service corporations that are variable interest entities as described in this Interpretation. If a service corporation is a variable interest entity, it is subject to the requirements of this Interpretation, and the consensus in Issue 95-6 does not apply. If a service corporation is not a variable interest entity, the consensus in Issue 95-6 continues to apply.

- b. Issue No. 96-21, “Implementation Issues in Accounting for Leasing Transactions involving Special-Purpose Entities”

The Task Force reached consensus on a number of issues related to implementation of the first and third conditions of Issue 90-15, which is nullified by this Interpretation. The questions that relate to implementation of those conditions are no longer necessary. Thus, this Interpretation nullifies Questions No. 1, 2, 3, 5, 7, 8, and 9 of Issue 96-21 and all but the first sentence in the response to Question No. 6. Questions No. 4, 10, and 11 and the remaining portion of Question No. 6 relate to matters that do not necessarily involve special-purpose entities and are not affected by this Interpretation.

- c. Issue No. 97-1, “Implementation Issues in Accounting for Lease Transactions, including Those Involving Special-Purpose Entities”

The Task Force reached consensus on the method of calculating depreciation for the purposes of determining earnings in applying the third condition of Issue 90-15, which is nullified by this Interpretation. Question No. 3, which relates to implementation of the conditions in Issue No. 90-15, is nullified because that issue has been nullified by this Interpretation.

- d. Issue No. 97-2, “Application of FASB Statement No. 94 and APB Opinion No. 16 to Physician Practice Management Entities and Certain Other Entities with Contractual Management Arrangements”

The Task Force reached consensus on a number of issues related to consolidations and business combinations related to physician practices and physician practice management entities. If the physician practice is a variable interest entity as described in this Interpretation, that entity is subject to the requirements of this Interpretation, and the consensus in Issue 97-2 does not apply. If a physician practice is not a variable interest entity, the consensus in Issue 97-2 continues to apply.

- D3. The provisions of this Interpretation bring conclusion to EITF Issue No. 84-30, “Sales of Loans to Special-Purpose Entities,” on which the Task Force was unable to reach consensus.

- D4. This Interpretation does not nullify EITF Issue No. 96-16, “Investor’s Accounting for an Investee When the Investor Has a Majority of the Voting Interest but the Minority Shareholder or Shareholders Have Certain Approval or Veto Rights.” Enterprises that are not controlled by the holder of a majority voting interest because of minority veto rights described in Issue 96-16 are not variable interest entities if the shareholders as a group have the power to control the enterprise and the equity investment meets the other requirements of this Interpretation.

